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Written Testimony

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Mr. Chairman and members of the Subcommittee, I am Tom Suber, president of the U.S. Dairy Export Council (USDEC). I am pleased to appear before you today to testify on the topic of “The Future of U.S. Economic Relations in the Western Hemisphere: Challenges and Opportunities for American Agriculture.”

The U.S. Dairy Export Council is a non-profit, independent membership organization that represents the export trade interests of U.S. milk producers, dairy cooperatives, proprietary processors, export traders and their allied industry suppliers. Its sole mission is to increase the volume and value of U.S. dairy product exports. USDEC maintains representative offices in Mexico City, Sao Paulo, Tokyo, Seoul, Hong Kong, Shanghai, Bangkok, Taipei, London and Lebanon to assist U.S. exporters and their customers. The Council receives the majority of its funds from Dairy Management, Inc., the organization responsible for managing the national farmer-funded dairy promotional assessment known as the dairy check-off. The export market promotion programs of USDA’s Foreign Agricultural Service provide the Council’s second highest source of revenue, followed by the annual dues of our 60 members.

America’s dairy industry is the second largest agricultural commodity sector in the United States, measured by farm cash receipts. The 80,000 U.S. dairy farmers live in every state of the Union, from Minnesota to Louisiana, and Vermont to California. Dairy is one of the top three agricultural sectors in fully half the states, and almost two-thirds of the members of the House hail from a “dairy” state.

Impressive as those numbers are, they represent only the milk <u>producer</u> side of the industry. Dairy <u>processors</u>, the companies that process milk into yogurt, cheese, ice cream and milk powder, add additional strength and nationwide employment to the industry’s impact as a whole on the country’s economy. In addition, our ability to increase milk production is limited only by demand, both domestic and international. Our ability to access and develop new markets is critical to the industry and to the overall rural economy.

Internationally, the U.S. is the world's largest single country producer of cow's milk. In 2002 the U.S. exported over $1 billion in assorted dairy products, the third consecutive year the industry exceeded that significant export benchmark. While that's an impressive number, it could be even larger if not for the price depressing export subsidies and high market access barriers of our competitors.

The U.S. Relations within the Western Hemisphere
What are our Opportunities?

The U.S. dairy industry supports all trade initiatives currently underway within the Hemisphere. Our members – processors, producers, and trading companies – are especially interested in the Free Trade Area of the Americas (FTAA) and the Central America Free Trade Agreement (CAFTA). The dairy industry also supports the recent introduction of S403, which would remove existing trading and travel impediments to Cuba. For the sake of simplicity, I will focus my comments on the FTAA as an indicator of the opportunities and threats that increased regional trade presents.

The Council believes that such trade initiatives within the Hemisphere are long overdue, as history shows we have lost ground to our trade competitors who aggressively pursued and continue to pursue such activities. For years, the United States has failed to profit from the potential economic benefits that would arise from greater trade links with the Western Hemisphere countries.

Although growing, U.S. dairy exports to Latin America – excluding Mexico – are relatively small. In 2002, we shipped $92 million of product into the region, or 9% of our total exports. This compares with the $309 million, or 30.3%, that goes to Mexico and Japan. In fact, despite our advantageous geographic proximity, EU dairy shipments into the region (again, excluding Mexico) amount to just under $400 million, more than four times those of the U.S. This extreme imbalance stems from two sources. One is the use of massive export subsidies to buy control of the market. The other is the use of special trading relationships that have built up over time. In addition to the EU's overpowering presence, dairy shipments to this region from Australia and New Zealand amounting to about another $400 million also present an opportunity to tap existing demand by creating closer trading relationships.

The potential for export growth is enormous. Every Latin American country except Argentina, Uruguay, Costa Rica and Nicaragua is a net importer of dairy products. Of these exceptions, only the first two generate significant exportable surpluses. The region as a whole imports three-and-a-half times as much dairy products as it exports. And the United States produces more milk, cheese, milk powder, whey and lactose than the other combined 34 countries in the hemisphere.

Latin America imports in excess of $2.2 billion worth of dairy products every year. The eleven largest countries import the milk equivalent of more than 13 billion pounds of milk annually – more milk than is produced in the states of Indiana and Minnesota in a year.

Total cheese imports for Latin America approach a quarter of a billion pounds a year, more than a month's output from Wisconsin, the largest U.S. cheese producing state. Latin America imports more than a billion pounds of milk powder annually, and buys more than 150 million pounds a year of whey proteins. These are significant numbers.

The middle and upper-middle classes are growing throughout Latin America – in Brazil, Peru and Chile in particular. Consumers with more disposable income are brand-conscious. They are interested in quality dairy products - a trait they strongly associate with the U.S., especially cheese and ice cream.

For example, despite being a sizeable milk-producing country, Brazilian consumers have a particular appetite for high-quality American products such as mozzarella and cream cheese. Meanwhile, in Peru, Colombia and Venezuela, food manufacturers use large amounts of U.S. dairy ingredients, including whey and milk powders. Additionally, the Caribbean islands, with their close proximity and high dependence on tourism, are attractive markets for high-value U.S. cheeses.

More importantly, Canada, our largest trading partner, with whom the United States has concluded trade agreements in the recent past, will be a significant market should an FTAA eliminate their tariffs on U.S. cheese (245 percent), butter (300 percent) and tight quotas on other U.S. dairy products.

Existing measures of per-capita consumption illustrate the potential demand for U.S. dairy products in a more open hemispheric trade environment. Annual dairy consumption in South America (excluding the large production bases in Argentina and Uruguay) averages 229 pounds per year. In Central America and the Caribbean, the average is 192 pounds. It is unrealistic to expect these countries to quickly achieve the levels of consumption in the United States and Canada, both around 585 pounds per year. However, it *is* realistic to see continuing growth as per capita incomes rise and begin to drive consumption to the levels that exist in Turkey, Pakistan or Russia (respectively, 321, 403 and 520 pounds per year). After all, Latin Americans use dairy products widely in their local diets and cuisine. Unlike Asian countries, where dairy products are rapidly building familiarity among non-traditional consumers, increased dairy demand by Latin American consumers is much more a matter of increased income and wealth, both factors that increased trade will foster.

We know we can improve our market position with respect to exports to the Hemisphere. The current trade imbalance with the EU and Oceania results from their heavy subsidies and product dumping, respectively, as well as on preferential treatment and long term relationships. We know we can change that, given the right tools. As an example, look at the development of U.S. dairy exports resulting from the initiation of NAFTA. Since 1995, when the NAFTA tariff advantage began its phase-in, exports of unsubsidized U.S. dairy products have jumped sharply. U.S. cheese exports have grown at an average annual rate of almost 6%, to the point where Mexico is now the largest destination for all U.S. cheese exports. Exports of whey products to Mexico have grown annually by 6.6%, ice cream by 1.1%, and lactose by 3%.

What are the Challenges?
Critical Issues for the U.S. Dairy Industry

The Council supports the U.S. goal of facilitating the process of ongoing hemispheric integration through trade. Furthermore, we support elimination of most, if not all, tariff and non-tariff barriers from the Arctic Circle to Tierra del Fuego, just as the North American Free Trade Agreement (NAFTA) has sought to do with the United States, Canada and Mexico.

The challenge will rest on negotiating an agreement that removes barriers within the hemisphere, but doesn't, as a consequence, leave the U.S. dairy industry vulnerable to the trade inequities that will remain in world dairy trade. Of particular importance to a balanced dairy sector agreement are the issues of rules of origin, third party export subsidies and the full inclusion of Canada.

Rules of origin

A fundamental concept of a regional trade agreement dictates that economic benefits accrue exclusively to the countries within the region. Consequently, the domestic industry's first and foremost objective is establishment of specific <u>rules</u>

of origin that ensure dairy trade benefits only the signatory countries. The United States is one of the most attractive dairy markets in the world, due to its high consumption, interest in top quality, innovative products and high domestic price. Consequently, dairy suppliers from around the world continually explore ways to expand their shipments to the U.S.

Milk's versatility creates the opportunity for that expansion by its great variety of tradable products – almost 400 individual tariff lines of the HTSUS include significant proportions of milk and dairy components. In the absence of appropriate rules of origin, it will no doubt be tempting for non-party countries to attempt to transship their dairy products through participating countries.

It is therefore extremely important to ensure that economic integration via the FTAA is restricted to dairy products produced from milk and dairy ingredients that originate solely from countries in the Hemisphere. The North American Free Trade Agreement (NAFTA) contains rules of origin for dairy products that effectively restrict transshipments through Mexico. In effect, NAFTA dictates that the milk or dairy product must come from a Mexican or American cow to gain NAFTA treatment. Products imported from outside the region must undergo a specific and substantial processing transformation to qualify for duty-free movement. Similar rules of origin were adopted for the FTA with Chile and must be included in the FTAA.

Third Party Export Subsidies

FTAA negotiations must address another key issue, that of export subsidies. The United States dairy industry is prepared to dismantle its export subsidies directed to markets in the Western Hemisphere only if we can ensure that our trading partners do not accept subsidized product from outside the hemisphere. If Brazil, for example, accepts subsidized product from the EU, while we trade away the ability to use our own Dairy Export Incentive Program (DEIP) to meet that subsidized competition, it will put us at a serious competitive disadvantage.

Over the past four years, the European Union provided an average of $1.44 billion dollars a year in dairy export subsidies, compared with an annual average of $91 million for the United States. In its most recent report to the WTO, the EU reported spending ***more than 100 times*** what the United States spent - $955 million versus $9 million. Further, in recent years subsidized dairy exports from Europe to all destinations totaled more than three times the total volume of butter imported by all Latin American nations, and approximately twice the total volume of all Latin American imports of cheese, skim milk powder and whole milk powder.

It is critical, therefore, that nations in the Americas agree not to accept subsidized dairy imports from outside the hemisphere if the United States is required not to subsidize products to compete in markets within the Hemisphere. In the absence of such provisions, a U.S. agreement not to subsidize into regional markets will effectively deny the United States substantial gains from closer trade relations.

Canada As a True Partner Within an Integrated Western Hemisphere

Finally, but most importantly, for the U.S. dairy industry the true economic value of Western Hemisphere trade cooperation is the inclusion of the Canadian dairy industry in any form of economic or trade integration. The U.S. dairy industry is united in agreement that a failure to bring Canada on board would substantially nullify any prospective net gains to closer regional integration.

In the U.S.-Canada FTA, in NAFTA and in its recent trade agreements with Chile and Costa Rica, Canada successfully kept dairy off the bargaining table in order to preserve its supply-management regime. The real challenge for FTAA negotiators will be to find a way to bring the Canadian dairy industry into the agreement. If Canada succeeds in excluding its dairy sector, the U.S. dairy industry would find little reason to support an FTAA.

Economic Impacts of a Potential Free Trade of the Americas

We believe that the overall, economic net benefits to the U.S. dairy industry from an FTAA agreement that adequately addresses the issues discussed above would be positive. However, if negotiations do not properly address any one of these issues, then the net benefits to the industry would be at best negligible and at worst would have a seriously negative impact.

In a 1998 analysis, USDA's Economic Research Service (ERS) used an economic model to examine the impacts of a FTAA on individual U.S. agricultural commodity sectors. For dairy, the ERS analysis <u>inexplicably</u> assumed that Canada would successfully exempt its dairy industry from the agreement, commenting only, "Barring changes in the conditions agreed to in the CFTA / NAFTA and the Uruguay Round, U.S. access to Canadian dairy markets will remain limited."

Using this assumption, and assuming as well that non-parties would not exploit or benefit from weak rules of origin and that third-party export subsidies were not an issue, the analysis concluded that, “dairy trade is unlikely to be significantly affected by an FTAA.”

On the positive side, the report concluded that U.S. dairy exports could displace some Argentine exports to Brazil, if the United States received the same free access to the Brazilian market that Argentina already has under the MERCOSUR agreement. In addition, the report noted, some expansion in markets in Central America is possible, if tariffs were eliminated. On the negative side, U.S. imports from Argentina could expand. Trade with our largest hemispheric trading partner, Mexico, will not likely be affected because U.S.-Mexico bilateral trade will already be free under the NAFTA, and most dairy exporting nations in South and Central America will have concluded bilateral free trade agreements with Mexico.

If the assumptions outlined in the report are part of the final FTAA, we agree with this scenario and analysis. Partly, it shows that while we may see some rise in imports, our export potential could far exceed the prospective imports. More importantly, it illustrates the tremendous importance for our industry of addressing the issues we have raised.

Lax FTAA rules of origin that permit transshipment of externally-produced dairy components into the U.S. market via FTAA partners would have a significant negative impact. The National Milk Producers Federation estimates that the quantity of these additional imports – above and beyond those that truly originate from FTAA members – could equal as much as 4 billion pounds per year, on a milk equivalent basis, following full FTAA implementation. This approximates the increase in total U.S. dairy imports resulting from the Uruguay Round agreement market access concessions, but without the roughly equivalent, and offsetting, growth in U.S. dairy exports the multilateral trade agreement also provided.

The abuse of rules of origin could lower milk prices received by U.S. producers by an average $.60 per hundredweight. Gross dairy farm revenues would drop by as much as $1.2 billion per year. Domestic dairy processors would also encounter substantial increased competition from imported dairy products such as cheese, evaporated milk, milk powder and butter, competition that would negatively affect employment and capital investment.

Similarly, if the FTAA provisions permit third parties to continue to use export subsidies to supply artificially cheap dairy products to FTAA members, then the potential growth in U.S. dairy exports to Brazil and Central America would likely not materialize. This would remove one of the counterweights to a probable increase of U.S. dairy imports from Argentina and Uruguay.

Today, Canada prohibits the importation of raw milk and commercial shipments of processed fluid milk products. It permits packaged fluid milk imports only as cross-border purchases by consumers for personal use only, and subject to a tariff-rate quota. Canada also imposes tariff-rate quotas on cream, concentrated milk, yogurt, buttermilk, whey powder, butter, cheese, ice cream, dairy ingredients and food preparations containing dairy components.

Including Canada's dairy industry in the FTAA would remove the prohibition on importation of raw milk and commercial packaged fluid milk. Among FTAA members, the United States would be the sole beneficiary of this liberalized access to the Canadian market. The United States would also probably be the major beneficiary of eliminating Canada's TRQs on dairy products. At the same time, the U.S. market would likely bear the biggest burden of any expanded dairy exports from Canada after regional market access barriers are removed.

Following full implementation of the FTAA, we estimate that the United States would gain net dairy trade into Canada amounting to about 5 percent of Canada's commercial dairy market, equivalent to about 1 billion pounds of milk. This would boost milk prices received by U.S. producers by about $.15 per hundredweight and would increase gross revenues received by U.S. dairy farmers by over $300 million per year.

Conclusion

In conclusion, the USDA / ERS analysis, combined with other industry estimates, indicates that the economic outcomes for the U.S. dairy industry from the FTAA could vary widely. Results could range from a loss for U.S. dairy producers of well over one billion dollars annually from a badly flawed agreement to a gain of over 300 million dollars per year from an agreement that fully addresses the issues and concerns we have raised in this testimony. The devil is truly in the details, and the support – or opposition – of our industry depends on the specifics of the agreement negotiated. We look forward to working with U.S. negotiators to achieve a good agreement for the FTAA and for the U.S. dairy industry, one that we would enthusiastically support.

Thank you for your invitation to present the dairy industry's views.